Dear Reviewer,

Thank you for your insightful comments. I address your concerns and comments by outlining the questions in order. I hope this letter sufficiently addresses your concerns. I welcome the opportunity to speak more with you about this article if any questions remain.

Referee 1 Comments:

1. For these results to be taken more seriously, it is important to perform robustness tests. For example, estimating different specifications of the model.

   My Response:

   As you suggest, to get some sense of the robustness of the results, I estimate alternative specifications by only including the lagged dependent variables as well as the differenced and lagged value of primary independent variables without the plethora of control variables in Tables 4 and 5.

2. The model results show that restrictive immigration policy does increase labor cost, but do not empirically establish how this induced increase in labor cost affects FDI.

   My Response:

   I agree with you that it is critical to see empirically how potential changes of labor costs would affect FDI inflows. However, my research does not expand the mediation model that examines the systematic relationship between changes in labor costs and FDI. My research solely focuses on empirically establishing how the induced policy changes on immigration affects FDI. Based on the positive direction between labor and capital flow as predicted by economic theory, I suggest, therefore, that restrictive immigration policy undermines foreign firms' investment decision indirectly by significantly increasing potential labor costs.

3. The result that an increase in government consumption spending lowers labor cost needs to be clarified and backed up with evidence from the literature.

   My Response:

   I believe, as you pointed out, that the relationship between government consumption expenditures and labor cost should be addressed although I intended to avoid redundant explanations on the impact of those control variables. Both the neoclassical and the New Keynesian models indicate that an increase in government consumption spending accompanies the increase of tax financing, which in turn induces a negative wealth effect by decreasing potential consumption and increasing labor supply. Thus, excessive labor supply causes a fall in labor cost as well as real wages (e.g., Barro, 1981; Baxter and King, 1993; Rotemberg & Woodford, 1992).

   References:

   Barro, R. J. (1981). Output effects of government purchases. *Journal of Political Economy*, 89(6): 1086-1121.

   Baxter, M., and King, R. G. (1993). Fiscal Policy in General Equilibrium. *American Economic Review*, 83(3): 315-334.

   Rotembert, J. J., and Woodford, M. (1992). Oligopolistic Pricing and the Effects of Aggregate Demand on Economic Activity. *Journal of Political Economy*, 100(6): 1153-1207.

4. The interpretation of how the estimated effect of market size on labor cost affects labor supply should be elaborated with examples from the literature. Also the explanation for the estimated effect of trade openness on labor cost needs more justification.
   My Response:
   I appreciate your suggestions on these points. It is important to note that the market size variable is operationalized as the market volume and potential by measuring the population growth in one country (e.g., Campbell and Hopenhayn, 2005). Indeed, labor market responses to population growth, and thus a larger population growth would increase labor supply in the market thereby decreasing labor costs (e.g., Bloom and Freeman, 1986; Jorgenson et al., 2008).

   Also, the structural change of labor market after trade liberalization not only decreases the fixed costs of production but increases the productivity of goods, which lead to the increase of the wage premium of skilled labor relatively to unskilled labor due to the increase in profits (Arbache et al., 2004; Comite et al., 2018). Many studies have also identified that a reduction in trade barriers increases the relative demand of skilled labor by reallocating factors toward more skill intensive firms (Burstein and Vogel, 2017; Feenstra and Hanson, 1997).

   References:
Arbache, J. S., Dickerson, A., and Green, F. (2004). Trade liberalization and wages in developing countries. *The Economic Journal*, 114(493): F73-F96.
Bloom, D. E., and Freeman, R. B. (1986). The effects of rapid population growth on labor supply and employment in developing countries. *Population and Development Review*, 12(3): 381-414.
Burstein, A., and Vogel, J. (2017). International trade, technology, and the skill premium. *Journal of Political Economy*, 125(5): 1356-1412.
Comite, F. D., Nocco, A., and Orefice, G. (2018). Trade liberalization and the wage gap: the role of vertical linkages and fixed costs. *Review of World Economics*, 154(1): 75-115.
Campbell, J. R., and Hopenhayn, H. A. (2005). Market size maters. *Journal of Industrial Economics*, 53(1): 1-25.
Feenstra, R. C., and Gordon, H. H. (1997). Foreign direct investments and relative wages: Evidence from Mexico's maquiladoras. *Journal of International Economics*, 42(3-4): 371-394.
Jorgenson, D. W, Goettle, R. j., Ho, M. S., Slesnick, D. T., and Wilcoxen, P. J. (2008). U.S. labor supply and demand in the long run. *Journal of Policy Modeling*, 30(4): 603-618.

5. An increase in Government consumption expenditure is usually viewed as bad macro policy that crowds out investment. However, Government expenditure on things like infrastructure investment is viewed as good for attracting FDI. Therefore it is not clear to me why an increase in government consumption expenditure is good for FDI.

My Response:
Thank you for pointing out this important question. I agree with you that there is a different economic impact of government consumption spending versus government infrastructure spending. Regardless of the government spending categories, what I understand is that economic theory does not clearly indicate whether the increase of government outlays would lead to better economic performance. According to Keynesian theory, government spending—particularly an increase in budget deficits—stimulates economic growth by enhancing purchasing power of individuals. Unlike Keynesians, some economists suggest that those debt-financed increase leads to higher interest rates, which would dampen potential investment. Despite different theoretical arguments on the impact of government spending, however, there exists the growing consensus in the empirical studies suggesting that government consumption spending including both non-market goods and individual social goods has little effect on subsequent economic growth (e.g., Barro, 1990; Connolly and Li, 2016; Hansson and Henrekson, 1994).

Actually, the empirical results from Table 4 (the impact of immigration policy on FDI) show the mixed results based on two different measures of immigration policy. As you see the coefficient estimates of the government consumption expenditures variables, both differenced and lagged values in the model that measures immigration policy as the annual refugee admission ceiling are *positively* associated with FDI inflows, but its effect is only marginally statistically significant with the differenced value. On the contrary, the coefficients of the government consumption expenditure variables are *negatively* correlated with FDI inflows in the model that measures immigration policy as immigration laws, but only the effect of lagged value of expenditure on FDI is statistically significant.

Although the different signs of the government consumption spending variable could be produced due to the different measures of immigration policy, the empirical results in this research basically suggest that while the impact of government consumption spending would preserve foreign investment in the short run, it would gradually decrease economic performance and thereby decreasing potential investment from foreign firms in the long run. These findings basically align with the existing arguments on the negative linkage between government consumption spending and growth.

References:
Barro, R. J. (1990). Government spending in a simple model of endogenous growth. *Journal of Political Economy*, 98(5): S103-S125.

Connolly, M., and Li, C. (2016). Government spending and economic growth in the OECD countries. *Journal of Economic Policy Reform*, 19(4): 386-395.

Hansson, P., and Henrekson, M. (1994). A new framework for testing the effect of government spending on growth and productivity. *Public Choice*, 81(3-4): 381–401.